Office of Chief Counsel
Internal Revenue Service

memorandum

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date: DEC 20 1999

to: Examination Division, Southern California District
ATTN: Rick Woods, CE1108

from: Associate District Counsel, Southern California District, San Diego

subject: [redacted] - Strategy to Generate Capital Losses

This memorandum responds to your request for advice regarding whether the purchase and sale of purchase money market preferred stock by [redacted] (the "Taxpayer") lacked economic substance.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the Taxpayer's purchase and sale of money market preferred stock lacked economic substance where:

a. the Taxpayer purchased money market preferred stock the day before a dividend was distributed with respect to such stock,
b. the Taxpayer was entitled to a 70-percent dividend received deduction pursuant to I.R.C. § 243 with respect to the dividends on such stock,
c. the Taxpayer sold the money market preferred stock [redacted] days later, and
d. the Taxpayer recognized a capital loss on the sale of such stock.

CONCLUSION

At this stage, we do not have sufficient information to reach a final determination on this issue. Below we describe additional information that may assist you in evaluating the merits of this issue. Once you have obtained the additional information, we will gladly assist you in analyzing it.

FACTS

[redacted] (the "Taxpayer") is a Delaware corporation engaged primarily as a government defense contractor. The Taxpayer and its subsidiaries file consolidated income tax returns on a fiscal year ending [redacted] basis.

During the years at issue, the Taxpayer had significant capital gains. In order to offset these gains, the Taxpayer pursued a strategy to generate capital losses. Pursuant to this strategy, the Taxpayer purchased money market preferred stock shortly "cum dividend."[1] The Taxpayer, therefore, paid a premium for the stock. The Taxpayer then sold the money market preferred stock "ex dividend"[2] [redacted] days later at par value.

The Taxpayer reported dividend income on the transaction and took a deduction pursuant to I.R.C. 246(a) for 70 percent of the

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[1] The term "cum dividend" refers to the purchase or sale of a share of stock where the purchaser is entitled to a declared dividend.

[2] The term "ex dividend" refers to the purchase or sale of a share of stock without the entitlement to a declared dividend.

dividend received. The Taxpayer also reported capital losses on the sale of the stock.

In a memorandum to file, the Taxpayer acknowledged the strategy to generate capital losses and also wrote:

[redacted]

See Memorandum to File dated [redacted].

The Taxpayer generally bought and sold the money market preferred stock through unit investment trusts held at [redacted] and [redacted]. The Taxpayer did, however, buy and sell individual money market preferred stock. In [redacted], for example, the Taxpayer engaged in the following transactions, among others:

Security	Date	Amount
[redacted]		
Purchased	[redacted]	$ [redacted]
Sold	[redacted]	[redacted]
Dividends		[redacted]
[redacted]		
Purchased	[redacted]	$ [redacted]
Sold	[redacted]	[redacted]
Dividend		[redacted]
[redacted]		
Purchased	[redacted]	$ [redacted]
Sold	[redacted]	[redacted]
Dividends		[redacted]

[redacted]

Purchased	[redacted]	$	[redacted]
Sold			
Dividends			[redacted]

[redacted]

Purchased	[redacted]	$	[redacted]
Sold			
Dividends			[redacted]

See [redacted] Year End Summary. The Service is currently analyzing the transactions of the unit investment trusts.

You argue that the Taxpayer should not be entitled to the dividend received deduction under I.R.C. § 243 or the capital loss, because the Taxpayer did not engage in the transactions described above for the purpose of making a profit.

DISCUSSION

Generally, a transaction has economic substance if it is "imbued with tax-independent considerations." Sheldon v. Commissioner, 94 T.C. 738, 759 (1990) (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 572 (1978)). In analyzing whether a transaction has economic substance, the courts have developed a two-prong test. Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1062 (1988) (citing Torres v. Commissioner, 88 T.C. 702, 718 (1987)). Under this test, the court will disregard the transaction if (1) the taxpayer was not motivated by any business purpose other than obtaining tax benefits and (2) the transaction had no economic substance, because there was no reasonable possibility of a profit. Id.

In this case, the Taxpayer bought and sold money market preferred stock for the purpose of generating capital losses. At the same time, the Taxpayer also received dividends subject to the 70-percent dividend received deduction. In looking at the transactions described above, the Taxpayer seemingly had an economic profit as a result of its program.

Cash from Money Market Preferred Stock

Purchases	$ [redacted]	
Sales	[redacted]	
Net Cash		[redacted]

Cash from Dividends

Dividends		[redacted]

Net Economic Profit $ [redacted]

It appears, therefore, that the Taxpayer's program had economic substance, because the Taxpayer had a reasonable expectation of profit and, in fact, did have a profit.

We recommend, however, that the Service investigate further before abandoning this issue. The Service should consider or obtain the following:

1. reports, analyses, proposals, memoranda, correspondence, or other similar documents describing the strategy employed by the Taxpayer, the economic effect of the strategy, and the tax savings associated with the strategy.

2. minutes of the board of directors authorizing the investments.

3. prospectus and other information relating to the Taxpayer's accounts at [redacted] and [redacted] and the unit investment trusts held at [redacted] and [redacted].

4. the method(s) used by the Taxpayer to finance the transactions.

   It looks as though the Taxpayer instituted the program in [redacted]. *See* [redacted] Year End Summary. In [redacted] and [redacted] the Taxpayer purchased approximately $ [redacted] in money market preferred stock (not including the unit investment trusts) before selling any such stock.

5. if the Taxpayer obtained loans in order to finance the transactions, the terms of the loans, including the interest rate, and the amount of interest deducted.

6. if the Taxpayer used cash from its bank accounts or other investments, the rate of return on those accounts or investments.

Without considering the loss, the Taxpayer is making [redacted] percent on its investments. (12 months x $[redacted] dividends received/2 months)/$[redacted] invested = [redacted].

Considering the loss, the Taxpayer is making [redacted] percent on its investments. (12 months x [redacted] dividends - $[redacted] loss)/2 months)/$[redacted] invested = [redacted]

This information may impact the analysis of whether the transactions resulted in, or were reasonably expected to result in, a profit for the Taxpayer and whether the Taxpayer had a purpose for entering the transactions other than tax purposes.

If you have any questions, please call the undersigned at (619) 557-6014.

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By: /s/
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